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Economics Department
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Eric B. Herr
Vice President-Economics

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U.S. BUSINESS OUTLOOK, SHORT-TERM

Executive Summary

Consumers downshifted their spending gears to super-low and business jammed on the investment brakes in 1980's second quarter. The result: Economic growth screeched to a halt and then lurched abruptly into reverse. Gross national product (GNP) in the April-June period plunged at an annual rate of 9.1%--as bad as the worst quarter of the severe 1973-75 recession. And final sales--GNP minus inventory change--plummeted by 9.6%, worse than any quarter of the last recession.

After dropping so far so fast, the economy subsequently will look good. Thus, it was an "encouraging" sign that the unemployment rate in July remained unchanged from June--at 7.8%.

Such news, however, appears good only through juxtaposition with second-quarter statistics, and should not obscure the fact that even after racing downhill at breakneck speed, the economy still has further down to go. Real GNP is forecast to fall at 5.1% and 0.5% annual rates in the third and fourth quarters, respectively.

The forces of recovery, however, are already gathering. Buoyed by substantial drops in mortgage rates and by declines in new-home prices, house buying has surged in recent months, and house building has started to come back. As housing demand recovers, so too will demand for the

big-ticket consumer durables that go into houses. But besides buying more washers and dryers, consumers are also expected to start buying more cars, even American-made cars. A prime driver of renewed auto demand will be improved liquidity positions of consumers: Since late last year, people have been reducing their debt burden (piled high during the 1979 spending spree) and they have been saving a greater portion of their incomes. As a consequence, the strain of paying off old debts plus interest is easing, and consumers will be seeking auto loans so they can replace the cars that should have been traded in months ago.

Once underway, the recovery is expected to progress at a modest pace. The economy is forecast to grow by only 0.8% in 1981; and by 1981's fourth quarter inflation-adjusted GNP is still expected to be slightly less than GNP in the first quarter of 1980. In other words, once recovery has begun, it should take about a year for the economy to get back to pre-recession levels of activity.

Key reasons for the slow recovery are that neither fiscal nor monetary policy are expected to be expansionary. Monetary policy, in particular, is assumed to stay relatively tight, so that rising interest rates early in the recession choke off some housing and auto demand.

Later in the recovery, however, this monetary policy would cool inflation, thereby reducing the inflation premium built into interest rates. In the event of moderating inflation and interest rates in late 1981, the stage would be set for solid growth in 1982 and beyond.